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TAB D

Summary of the CIA Input into NSSD 2-85

The economies of the region have been hard hit since the late 1970s by the combined effects of a dramatic deterioration in the international terms of trade, generally inadequate domestic economic policy adjustments, and unprecedented political turmoil.

-- On the international front, the fall in the region's terms of trade was touched off by sharply lower coffee prices in 1978 and a doubling of imported oil prices during 1979-1980. Relative trading prices steadily worsened through 1984.

-- Internally, governments have not been able to reduce spending in the face of an eroding foreign trade tax base and the need to increase defense spending. Efforts to maintain consumption levels have boosted public budget and foreign trade deficits, aggravated inflation, and undermined currency stability.

-- With Nicaragua as the backdrop, regional instability has skyrocketed. Insurgencies have shaken El Salvador and Guatemala while Honduras and Costa Rica suffered the spill-over effect.

From a regional standpoint, political turmoil and economic development problems have been mutually reinforcing.

-- Insurgencies have damaged transportation networks, power and water systems, and other infrastructure in El Salvador and, to a lesser extent, in Guatemala.

-- Intimidation of workers in much of the region has reduced traditional movements of laborers, cut harvests, and boosted food import needs.

-- Compromising economic policies that provided a short-term cushion for political expediency have worsened foreign trade positions, fueled inflation, and discouraged investments.

-- Intra-regional trade has fallen sharply, particularly within the Central American Common Market (CACM), which had been the basis for the region's earlier industrial development.

As a result of these factors, per capita incomes and living standards in the region have steadily declined since 1978.

-- During 1978-84, the region's average per capita income fell over 20 percent.

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-- Deterioration was most severe in El Salvador where real per capita income is now one third less than it was in 1978.

-- Only Panama bucked the trend for a while showing some expansion in living standards through 1982 because of aggressive public spending programs supported by higher canal revenues and strong foreign investments. Since 1983, per capita incomes there have dropped as regional contagion effect caught up with Panama.

There are a number of potential economic economic growth tracks that Central America might follow during the rest of the century. The exact path will depend on a number of internal and external considerations.

-- A low growth path could become a reality if US aid falls off, responsive economic policies are not developed locally, and political instability remains high as Managua sticks to its present course.

-- A high growth path that would return living standards to previous peak levels by 1990-as called for by the Kissinger Commission report--would require the combination of regional peace, full US financial assistance, and domestic economic policies that encourage investment and export expansion.

-- In reality a medium path seems more likely, the peace setting assumed by the Commission has failed to emerge and is unlikely to do so as long as Managua continues to march down its current policy path. Moreover local governments have been unable to adopt the policy changes envisioned by the Commission.

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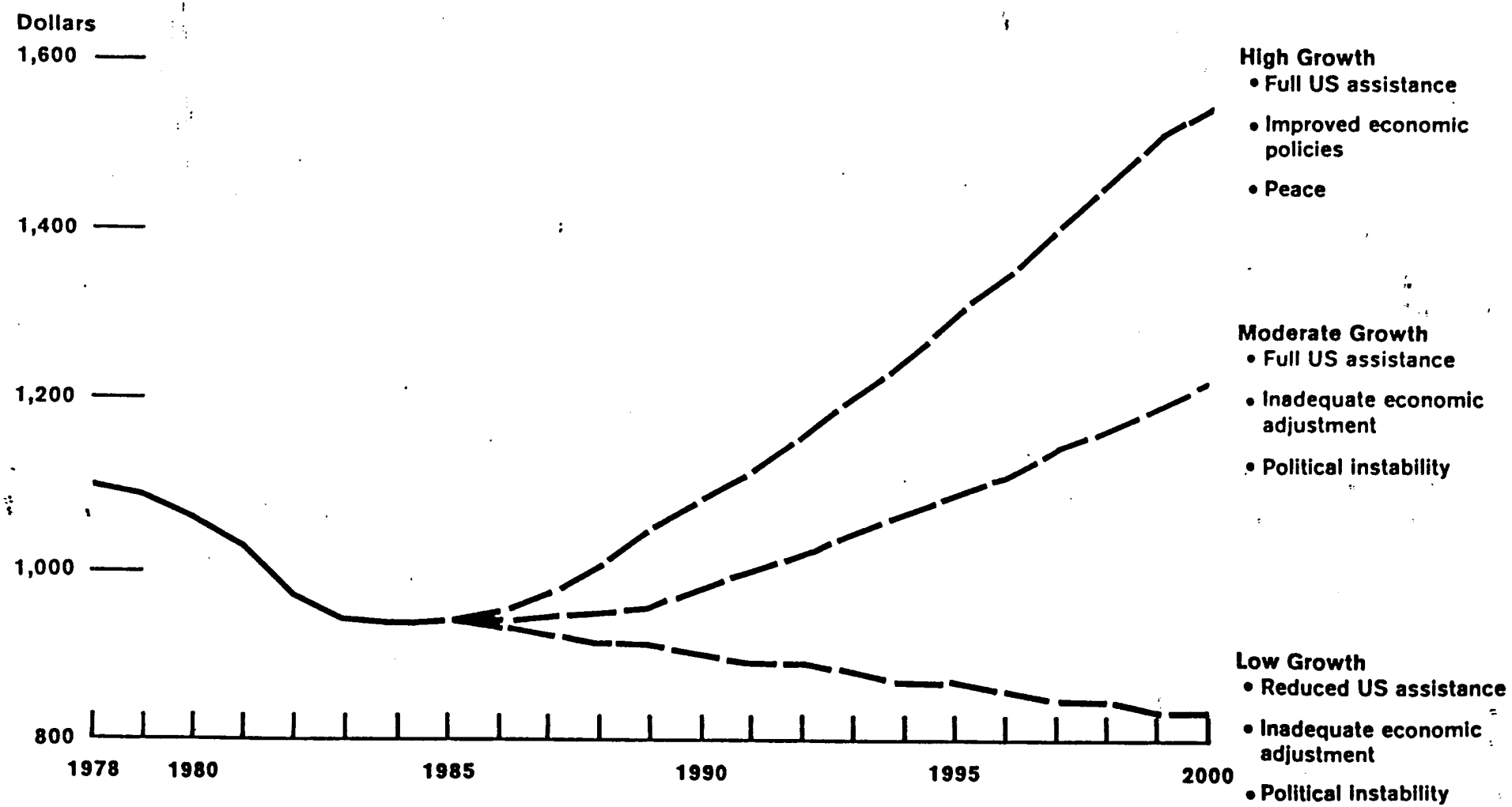
Central America: Per Capita Income Trends



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Belize

The economy grew by only 2 percent in 1984 for the second consecutive year, but longer term prospects are expected to be somewhat brighter.

-- The new Prime Minister inherited a lackluster economy with a large and inefficient public sector.

-- Esquivel's free-market orientation has sparked widespread optimism in the private sector and among foreign investors.

-- An IMF agreement was finalized late in the year and should improve financial flows.

-- The balance-of-payments improved slightly on the strength of exports to the United States.

-- Inflation was held to only 3 percent while unemployment held steady at 14 percent.

Stronger growth is expected in 1985 as new investments in export industries begin to bear fruit.

-- Esquivel already has moved to improve government finances by limiting spending and raising taxes, and he intends to adhere to IMF guidelines.

-- Further expansion of trade to the United States is expected as a result of export-oriented investment encouraged by the CBI legislation.

-- Larger US aid will increase foreign exchange availability and help maintain productive imports.

-- A reduction in the US sugar quota and depressed world sugar prices, however will take their toll.

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Costa Rica

Costa Rica's economy performed better than any other in the region during 1984.

-- As of January we had estimated 1984 GDP growth at 3.4 percent. Based on subsequent US Embassy reporting, we now believe economic growth may have been high as 5.5 percent.

-- The strong performance was led by export expansion, which grew by 10 percent , as coffee and nontraditional exports did well. The higher exports allowed imports to increase apace.

-- Higher imports allowed domestic inflation to hold steady at 12 percent.

-- Dynamic growth, however, renewed pressures on the budget and foreign payments by yearend and required San Jose to go back to the IMF to get financial support needed to catch up with debt payment obligations.

We expect export problems and austerity requirements to slow the economic recovery this year.

-- In April the IMF endorsed Costa Rica's new austerity program that features a reduction in public spending and imports.

-- Banana sales will fall $30 million to $50 million this year because poor world prices and high Costa Rican prices encouraged international producers substantially to scale back plantings. At the end of 1984, one major company, in fact, curtailed operations and has since agreed to sell out to the government.

Costa Rica's success in restoring self sustaining economic growth will continue to be challenged by a number of obstacles.

-- San Jose's large debt will keep pressures on balance of payments for the forseable future; its debt is currently over $4 billion. Previous large public deficits have made Costa Rican debt service problems the most intractable in the region.

-- Growing numbers of refugees streaming into the country from Nicaragua complicate budget problems by straining existing resources.

-- Efforts to encourage private investment by reducing production controls and continuing to adjust exchange rates will have to be reinforced to boost export capability.

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El Salvador

The Salvadoran economy grew by a modest 1.5 percent in 1984, arresting a steep decline that began in 1979.

-- Inflation remained at about 13 percent despite strong budget pressures imposed by the war.

-- The balance of payments benefited from higher US aid and worker remittances, but nevertheless deteriorated slightly as import expansion outpaced export growth.

-- The level of unemployment remained about 30 percent and much of the industrial capacity was underutilized.

Various independent estimates suggest real GDP is likely to grow 2-3 percent in 1985.

-- The improved military showing against the insurgency is lowering the principal barrier to growth and raising confidence in the economy.

-- Nevertheless, Duarte will have to deal with unpopular economic adjustments including tax reform and currency devaluation to meet disbursement conditions for US economic aid during the rest of this year.

Long term improvement of depressed living standards will come slowly as sustained growth on a per capita basis still faces many obstacles.

-- As insurgent fortunes have waned, the rebels have intensified attacks on economic targets that prove difficult to defend.

-- Spending for defense and security takes nearly 30 percent of the national budget, aggravating inflationary pressures and squeezing out funding for public investments.

-- Wage demands to restore eroded living standards will intensify and be encouraged by leftist agitators.

-- Despite recent improvements, continued poor government-business relations constrain repatriation of capital and large-scale investment by either local or foreign businesses.

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Guatemala

The economy stagnated in 1984 and registered the fourth consecutive year of declining per capita income and living standards.

-- Foreign trade and financial accounts substantially worsened.

-- By mid-year, Guatemala had fallen out of compliance with IMF standby conditions; during 1984 tax revenues covered only one-half of spending and a growing share of the public deficit had to be financed internally.

We expect little or no real growth in the economy again during 1985.

-- Foreign exchange shortages continue to worsen as the government struggles to meet petroleum payments and foreign debt obligations.

-- Fuel shortages and electricity brown-outs are cutting productivity, and inflation is on the rise.

-- One bright spot is the export sector which has been stimulated by the exchange movement.

Failure to achieve a national concensus on economic policies is likely to make growth even more difficult.

-- Chief of State Mejia has already yielded to domestic pressures and withdrawn the austerity program announced in April.

-- National consultation to establish an alternative set of austerity measures is proceeding slowly, probably will emphasize budget cuts rather than tax increases, and will fail to reduce the deficit significantly or pave the way for an IMF agreement.

The civilian president will inherit a faltering economy, but can expect some relief.

-- Multilateral and bilateral aid flows will likely pick up once the transition to civilian rule takes place, particularly if some austerity measures are adopted.

-- A major hydroelectric plant is scheduled to open next year, substantially cutting fuel imports and providing more reliable electricity supplies.

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Honduras

The economy grew by 2.8 percent in 1984, supported by a sharp increase in government spending and foreign economic assistance.

-- Revenues rose 20 percent from a mid-year tax increase and higher trade volumes, but was outpaced by spending as the deficit expanded to 12 percent of GDP.

-- The balance of payments deteriorated in the current account but was largely offset by an infusion of funding from non-commercial sources.

-- The government continued to postpone currency adjustment, despite effective devaluations by Central American trading partners.

-- Inflation fell to 5 percent, but no dent was made in the 25 percent unemployment and 50 percent underemployment.

Growth of 2-3 percent is likely again in 1985, but overdue economic adjustments will be further delayed in this election year.

-- Honduras will receive US aid disbursements with minimal conditions for policy reform.

-- Economic advisors are unwilling to lobby an unreceptive president for policy changes that entail political costs.

-- Domestic borrowing to finance the deficit will help accelerate inflation

-- The balance-of-payments will be helped by reduced fuel imports following the opening of a major hydroelectric project, but the trade deficit will grow as export earnings stagnate.

Tough choices will confront the next president as a result of Sauzo's inaction on the economy.

-- Public sector spending will have to be trimmed to reduce growing budget pressures.

-- Currency controls will have to be loosened to revive employment-generating industries and to encourage new investments.

-- Improved incentives for non-traditional exports will be needed to compensate for the stagnation of agricultural-based exports.

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Panama

Panama's economic situation has deteriorated rapidly since the current recession began in 1983. Recent IMF estimates and US Embassy reporting indicate that in 1984 Panama's GDP fell by 1.2 percent.

-- Lower export earnings and higher debt service obligations caused Panama City to cut imports substantially, trim public works projects, and reduce domestic credit for the private sector during 1982 and 1983.

-- Panama's banking sector--which in recent years has provided nearly 10 percent of GDP--was hard hit by the fallout of the Latin American debt crisis. Banks operating in Panama began to cut their Latin American exposures and reduce local staffs.

-- As regional political and economic problems mounted and Panamanian resources began to dry up, the military government--which had been in power since 1968--belatedly adopted austerity and scheduled elections to turn control over to a civilian government.

We expect a further decline in economic activity this year.

-- President Barletta's early attempts to ram an austerity package through the legislature failed, and subsequent protacted and indecisive budget negotiations have delayed an IMF standby program and World Bank Structural Adjustment loan. Commercial bankers are waiting for these steps before they reschedule $600 million in debt due during 1985-86.

-- Business is suffering from the lack of action. Domestic credit has fallen and the government is delaying payments for goods and services received from the private sector.

-- International banking continues to cut back. The US Embassy reports that within the past several months the Bank of America has laid off 400 workers while Chase Manhatten has reduced its workforce by 200 slots.

A number of obstacles will hinder economic recovery over the longer term.

-- Until economic decisionmaking is sorted out, Panama will be unable to regain normal access to international financial markets or encourage private investors from developing export capacity.

-- Traditional exports are largely agricultural and will likely continue to suffer from weak international prices.

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